United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING EN BANC

77-5034

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In re APPLIED LOGIC CORPORATION,

Bankrupt,

NEW JERSEY NATIONAL BANK,

Plaintiff-Appellant,

-against-

DANIEL GUTTERMAN, as Trustee of APPLIED LOGIC CORPORATION, Bankrupt,

Defendant-Appellee.

UNITED STATES COURT OF APPEALS
MAY 18 1978
SECOND CIRCUIT

On Appeal from the United States District Court for the Southern District of New York

PETITION FOR REHEARING EN BANC

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Introductory Statement

Defendant-appellee Daniel Gutterman, as trustee in bankruptcy of Applied Logic Corporation, bankrupt (hereinafter the "Trustee") petitions for a rehearing of the Order of this Court filed herein on April 27, 1978 which reversed the orders and findings of fact made by both District Judge Gerald L. Goettel and Bankruptcy Judge Roy Babitt.

Pursuant to Fed. R. App. P., Rule 25, this petition should be reheard en banc because it involves questions of exceptional importance, consideration of which are necessary to secure uniformity in this Court's decisions.

Questions of Exceptional Importance Requiring a Rehearing En Banc

This Court stated that "the case is close."

Nevertheless, this Court erroneously reversed the factual findings made below by the Bankruptcy Judge and the District Court Judge, on the improper ground that the testimony below in support of such factual findings was "ambiguous." At best, this Court should have remanded the matter for further testimony.

This Court also found that the absence of certain testimony by other witnesses "justifies a strong inference" as to contrary factual findings.

This Court employed an improper standing to reverse affirmed factual findings made below. The only proper standard for such a reversal is the "clearly erroneous" standard.

In addition, this Court found for the first and only time that an implied or constructive special account cannot defeat a bank's right of set-off. Such a finding is diametrically contradictory to the holdings of the Fifth, Eighth and Ninth Circuits, as well as contradictory (at least in spirit) to this Court's recent holding by a different panel in Katz v. The First National Bank of Glen Head.

Contrary to this panel's opinion, the "sanctity" of any principle favoring set-offs by banks was in no way violated by the holdings below.

Both courts below found as a fact that the creditor parties to the refinancing and recapitalization agreements recognized that the account at New Jersey

National Bank ("the Bank") was established, not for the benefit of the Bank, but for the benefit of all such creditors. This Court summarily and improperly reversed that factual conclusion.

This Court's reinterpretation of the facts was not only contradictory to the factual findings below, but was senseless. It is inconceivable that the debtor would raise $500,000 from friends and stockholders and deposit this fresh cash in certificates of deposit for the sole benefit of the Bank.

Judge Friendly held that the creditors should have required an express written waiver of set-off from the Bank. Those creditors failed to do so. They didn't do so because the agreements required the establishment of a "special account." The courts below correctly found as a fact that all of the other creditor parties intended that the arrangements themselves demonstrated that the Bank relinquished the right of set-off. Such a factual finding below was fully supported by the record. Even if it were not supported by the record below, remand was the proper disposition - not reversal.

ARGUMENT

POINT I. REARGUMENT SHOULD BE GRANTED, BECAUSE THIS COURT'S HOLDING THAT BANKRUPTCY ACT § 68a PRECLUDES THE APPLICATION OF EQUITABLE PRINCIPLES CONFLICTS WITH CUMBERLAND GLASS MANUFACTURERS CO. V. DE WITT

In concluding that the courts below erred in their "basic approach" to the matter before them, this Court held that Bankruptcy Act § 68a must be strictly construed because bankruptcy courts are not "free to apply [it] when they think application would be 'unjust'." What this Court appears to have said, therefore, is that in the context of Bankruptcy Act § 68a, equitable principles have no place.

Such a holding is at odds with all prior authority construing this section of the Bankruptcy Act, as well as the general scheme of the Act itself. See Bankruptcy Act § 2a, which provides that bankruptcy courts are courts of equity. See also Collier on Bankruptcy, 14 Edn., ¶ 2.09. Thus, the bankruptcy court will look through the form to the substance of any particular transaction. Id.; Pepper v. Litton, 308 U.S. 295 (1939).

In dealing with Bankruptcy Act § 68a the Federal courts have unanimously held that this provision should be applied based on equitable principles. This doctrine was espoused by the Supreme Court in Cumberland Glass Manufacturing Co. v. De Witt, 237 U.S. 447, 454, 455 (1915):

> "The object of [§ 68a] is to permit, as its terms declare, the statement of the account between the bankrupt and the creditor, with a view to the application of the doctrine of set-off between mutual debts and credits. The provision is permissive rather than mandatory. . . . The matter is placed within the control of the bankruptcy court, which exercises its discretion in these [set off] cases upon the general principles of equity. . . ." (Emphasis added.)

Thus, in Brunswick Corp. v. Clements, 424 F.2d 673, 675 (6th Cir. 1970), cert. denied 400 U.S. 1013 (1971), the Sixth Circuit held:

> "The phrasing of Section 68(a) might seem to require an interpretation that set offs in bankruptcy are mandatory when mutual debts or mutual credits exist. However, this is clearly not the case. . . . Moreover, while the right of set-off is discretionary in the bankruptcy court, Prudential Insurance Co. of America v. Nelson, [101 F.2d 441 (6th Cir. 1939), cert. denied 308 U.S. 583 (1939)], Tucson House Construction Co. v. Fulford, 378 F.2d 735 (9th Cir. 1967), the court must exercise its discretion under the general rules and principles

> of equity. Scott v. Armstrong, 146 U.S. 499 (1892); In Matter of Rosenbaum Grain Corp. 103 F.2d 656 (7th Cir. 1939). Thus, where justice and equity dictate that a set off be denied, it must be. See, e.g.'s In Matter of Garfunkel and Tauster, 8 F.2d 790 (2d Cir. 1924); Burnes National Bank v. Mueller-Keller Candy Co., 86 F.2d 252 (8th Cir. 1936); Clark Bros. & Co. v. Pou, 20 F.2d 74 (4th Cir. 1927). . . ."

See also In re Potts, 142 F.2d 883 (6th Cir. 1944), cert. denied 324 U.S. 868 (1944); In re Brewster-Raymond Corp., 344 F.2d 903 (6th Cir. 1965); In re Jonker Corp., 385 F.Supp. 327 (D. Md. 1974); In re Williams, 422 F.Supp. 342 (N.D. Ga. 1976); Binnick v. Avco Financial Services of Nebraska, 435 F. Supp. 359 (D. Neb. 1977), and the cases cited by the Bankruptcy Judge in his opinion.

Furthermore, the bankruptcy court, as a court of equity, will be even more inclined to deny a set off in a Chapter XI proceeding where the debtor's continued vitality is of more concern than the payment of claims as in a straight bankruptcy. It should be noted that ALC's Chapter XI proceeding failed because it did not have available the funds set off by the Bank.

Thus, in Diversa-Graphics, Inc. v. Management & Technical Services Co., 561 F.2d 725, 727, 728 (8th Cir. 1977), the Court of Appeals held:

> "Section 68 of the Bankruptcy Act. . . is applicable to Chapter XI proceedings. . . .
>
> The purposes of Chapter XI proceedings are similar to those of reorganizations under Chapter X and § 77 in that the objective in each case is the continued vitality of the debtor organization . . . It has been recognized that in some cases, in order to protect the financial status of the debtor, set offs should not be allowed in reorganization proceedings. See Kagel v. First Commonwealth Co., 534 F.2d 194, 195 (9th Cir. 1976); Susquehanna Chemical Corp. v. Producers Bank & Trust Co., 174 F.2d 783, 786-7 (3d Cir. 1949) . . . ."

See Baker v. Gold Seal Liquors, Inc., 417 U.S. 467 (1967). The theory behind these cases is the same - although § 68a permits a set-off, on equitable principles it will not be permitted.

Equitable considerations were at the very heart of Bankruptcy Judge Babitt's decision, as they were of District Judge Coettel's affirmance. Basing his decision on all the circumstances that led to the 1970 and 1971 agreements and the implementation of those agreements as monitored and controlled by the Bank, the

Bankruptcy Judge held that the Bank was estopped to assert a right of set-off. Judge Babitt found that the Bank, in agreeing to hold the funds raised by ALC as required under the terms of the 1971 agreement in an account at the Bank, in agreeing to share pro-rata with the other creditors, in agreeing to the special payout provisions of the 1971 agreement and in agreeing to monitor ALC's account on behalf of the other creditors, had placed itself on an equal footing with the other creditors. As Judge Babitt found, in these circumstances it was incumbent upon the Bank, having in effect placed itself in the same status as other creditors, to expressly state that it was retaining its right to set-off, if that was the intention.

The reliance by the courts below on First National Bank of Portland v. Dudley, 231 F.2d 396 (9th Cir. 1956) was based in large part upon the equitable considerations that compelled that court to deny the bank any claim to set-off. As in that case, the funds deposited into the account in question were not "general funds" - here, the funds had been raised by ALC as as required by the 1971 agreement. So too, in the instant

action, the bankruptcy court found that based upon all the facts, equitable considerations required that the set-off should be denied. Judge Babitt found that the intent of the parties was that the Bank had waived its right of set off. Absent an express statement of retention of any right to set off, the Bank could not assert such a right at a later time.

Accordingly, it is submitted that this Court should grant a rehearing because basic equitable principles do apply to the implementation of Bankruptcy Act § 68(a) and these principles, overlooked or rejected by this Court in its decision of April 27, 1978, as applied to the facts of this action were the basis of the decisions of the courts below correctly denying the Bank a claim of set off.

POINT II. REARGUMENT SHOULD BE GRANTED, BECAUSE UNDER BANKRUPTCY RULE 810 THIS COURT MAY NOT SUBSTITUTE ITS OWN FINDINGS OF FACT

A reading of this Court's decision reversing the judgments of the courts below leaves no doubt that it was strongly swayed by policy considerations, regardless of the equities involved. It must initially be pointed out that the Bank's claim that an affirmance by this Court would wreck havoc in the business

community was unjustified. Here the courts below had found that equitable principles applying to the facts of the case - especially the fact that the Bank had agreed to share rateably with other creditors - precluded a right of set-off. There was nothing to stop the Bank from expressly reserving a right of set off, as it should have done. And if the same fact pattern were to arise again, it would be a simple matter for a bank to expressly reserve that right.

In seeking to justify its decision on policy grounds, however, this Court set about deemphasizing the role played by the Bank. Thus, it emphasized the fact that the Bank's representative on the ALC board of directors was in the minority (Opinion, 2800 n 17); that the fact that Lynch was at the board meeting at which it was decided not to set up the special account was not significant (id., 2800, n 17); that it was not significant that the Bank monitored both the account and ALC's affairs through the position of Lynch (id., 2800); that the extent of the Bank's monitoring was not substantial (id., 2800); that the fact that the 1970 agreement consolidated the debts owed to the Bank and other creditors into two notes to be held by the Bank did not constitute proof that the Bank

agreed not to exercise its right of set off (id., 2800); that the fact that ALC agreed to use the Bank as its sole depository was also not relevant to the question of set off (id., 2800).

Moreover, this Court completely discounted the testimony of ALC's witness Mobach because it conflicted with that of the Bank's witness, Lynch (id., 2790-91). Furthermore, this Court apparently found no force in the bankruptcy court's finding that the Bank had played a key role in orchestrating matters and that while ALC's account at the Bank may have originally been a general account, the circumstances surrounding the funding of the account and the Bank's conduct in monitoring the account and ALC's affairs changed the nature of the account to a special account.

In effect what this Court did in its decision was to discount the findings of the bankruptcy judge. It held that those findings were not important, ignoring the crucial point that these findings were part of the overall picture that led the bankruptcy judge to hold that the Bank could not claim a right to set off because it was the intent of the parties that that right should not be retained. It is submitted that this Court was not permitted to discount the findings made by the bankruptcy judge, even if it may not have agreed with them, unless it found that they were "clearly erroneous."

Bankruptcy Rule 810 provides that the bankruptcy judge's findings must be accepted unless "clearly erroneous." Appellate courts are not entitled to substitute their own interpretation of the facts merely because they may not agree with the interpretation of the bankruptcy judge. Rivas v. Jefferson, 412 F.2d 769 (th Cir. 1969). See also In Re Transystems, Inc., CCH Bankruptcy Rep. ¶66,772 (5th Cir. 1978) which held that findings as to the intent of the parties were findings of fact to which the "clearly erroneous" test applied.

Moreover, this Court failed to give due regard to the opportunity of the bankruptcy judge to judge the credibility of the witnesses, as it is required to do under Bankruptcy Rule 810. Thus, the bankruptcy judge had clearly resolved the issue of the conflict in evidence between Mobach and Lynch in favor of ALC. This Court, however, disregarded that holding by stating that the conflict was "unresolved."

In reaching its decision, the bankruptcy court took all factors into consideration and found that in the light of the overall picture the Bank's purported set off should be denied. In its decision, this Court sought to distinguish specific findings by the bankruptcy judge without taking them in their overall context. Furthermore, the bankruptcy judge's determination to give more weight to

the evidence of Mobach than Lynch was a result of his seeing the witnesses and being able to judge their credibility. This Court was not entitled to ignore that determination. At best, all this Court has power to do is to remand for further factual determinations not inconsistent with principles of law.

POINT III. REARGUMENT SHOULD BE GRANTED, BECAUSE, ASSUMING THE SET OFF WAS VALID, THE FUNDS SO SET OFF SHOULD FIRST BE APPLIED TO THE BANK'S SECURED DEBT

Having held that the purported set offs by the Bank were proper, this Court then proceeded to hold that the funds should be applied first to the Bank's unsecured debt. This Court held that the bankruptcy judge "overread" the provisions of paragraph 8(a) of the 1971 agreement because that provision only dealt with the order of application of the "specified cash flow" and not with "how creditors must apply monies that came into their hands."

In so holding, this Court seems to have ignored the fact that no matter how one is to view the situation, ALC's account at the Bank included any funds that under the terms of the 1971 agreement were envisioned as applicable to the "special cash flow." This Court seems to imply in its decision that if a special account had been set up as envisaged by the 1971 agreement, the funds in

that account would have been immune from any set off by the Bank. At the Bank's suggestion no such special account was set up, but all ALC's banking, including the "special cash flow" was done through the one account.

Accordingly, it is incorrect for this Court to categorically state that the funds in ALC's account "came into the Bank's hands" and that accordingly they were entirely immune from the provisions of paragraph 8(a) of the 1971 Agreement. It is submitted that the Bankruptcy Judge correctly applied the provisions of said paragraph 8(a) to the funds set off by the Bank.

Conclusion

This Court should grant the Trustee's petition for a rehearing en banc because of the importance of the questions involved, consideration of which is necessary to ensure uniformity in this Court's decisions.

Respectfully submitted,

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